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No. 432

LOS ANGELES GAS AND ELECTRIC CORPORATION,

Appellant,

vs.

RAILROAD COMMISSION OF THE STATE OF CALIFORNIA, ET AL.,

Appellees,

CITY OF LOS ANGELES,

Intervener.

REPLY BRIEF FOR APPELLANT.

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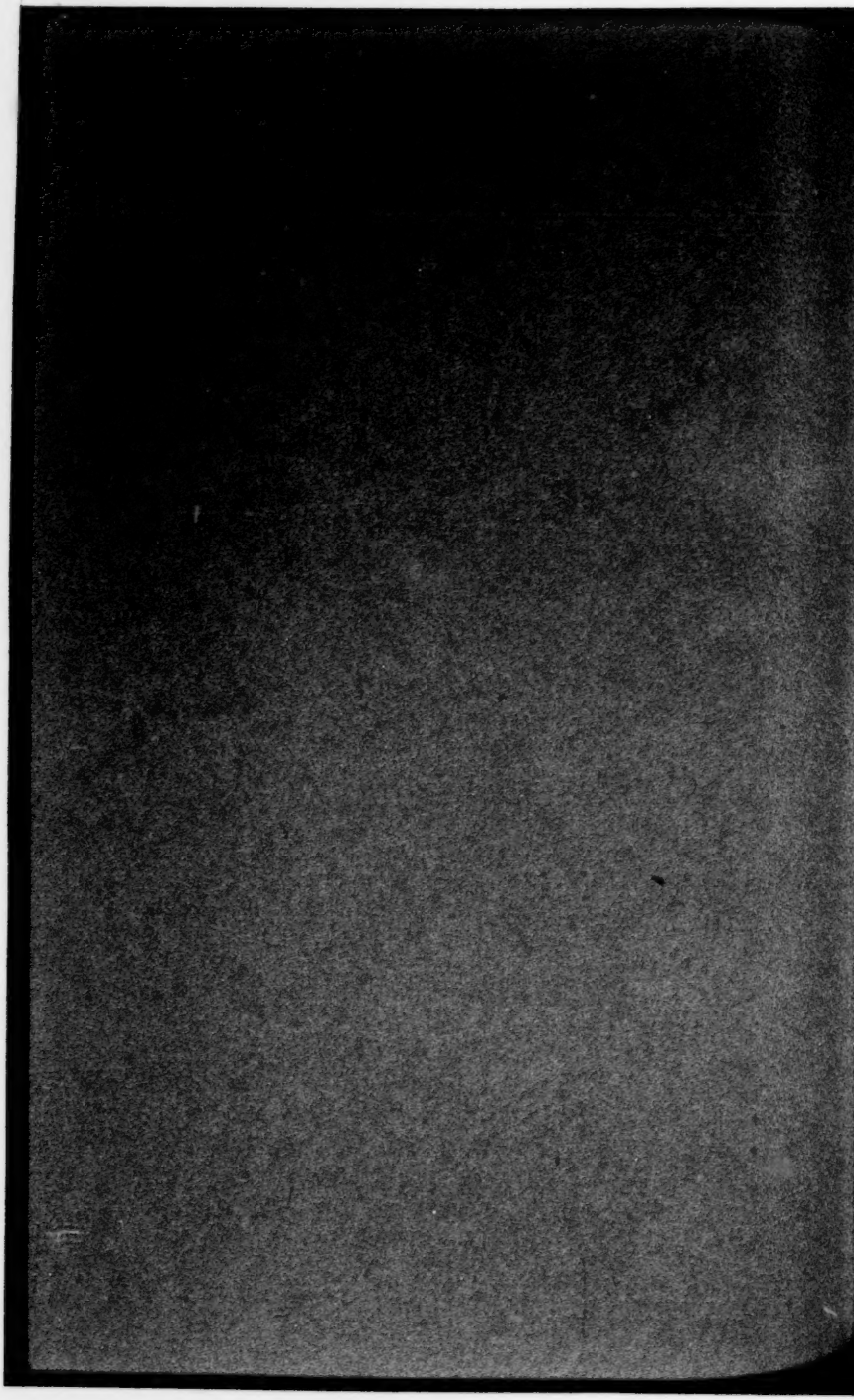

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1932.

No. 412

LOS ANGELES GAS AND ELECTRIC CORPORATION,

Appellant,

vs.

RAILROAD COMMISSION OF THE STATE OF CALIFORNIA, ET AL.,

Appellees,

CITY OF LOS ANGELES,

Intervener.

REPLY BRIEF FOR APPELLANT.

The Commission's[1] decision in this case asserts the superiority of its long established historical cost rate making formula over the fair value rule established by the decisions of this Court, although it insists that actual cost may be disregarded in this case because of a quasi-estoppel arising

[1] The Railroad Commission of the State of California is herein referred to as the Commission, Appellant is referred to as the Company.
Unless otherwise indicated all emphasis herein has been supplied by us.

from admittedly erroneous book entries. The fair value rule is roundly criticised and it claims that reproduction cost is valueless as evidence (R. 39) and excludes it from consideration as "too uncertain and hypothetical to enter into a rate base figure." (R. 44) It fixes fair value by giving "dominant consideration" to what it says is "cost with adjustments for changes in price level" (R. 40), but uses in arriving at that figure (as shown by the dissenting opinion (R. 70) and by its answer (R. 91)) a reproduction inventory, applying spot prices of June 15, 1930, and including 6.35 per cent for overhead construction costs, an amount shown by its own engineers to be hardly more than half the actual historical cost. It expressly refuses any allowance for going value on the ground that the cost of building up the business had been paid out of operating expense. (R. 42)

In the court below this position was adhered to and that court gave express approval to the rejection of actual overhead construction costs in favor of erroneous book entries (R. 116) and to the rejection of any allowance for going value (R. 117).[1] By its finding that the values fixed by the Commission are the reasonable values of the property (R. 204) the court below gave a general approval to all of the theories and methods of the Commission. Throughout the proceedings there was included in the property valued, on the same basis as all other property, the Company's gas manufacturing plant, as shown by both the majority opinion (R. 112) and by the concurring opinion (R. 153) in the court below.

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[1] The decision of the court below has been cited by the Commission in a rate case as authority for refusing any allowance for going value, and for rejecting actual cost where erroneously charged on the books to operating expense. *Re Southern California Gas Co.*, Decision No. 25,348, decided November 9, 1932, not yet printed.

As we construe the Commission's brief in this Court, it, in effect, abandons every theory and principle upon which the decision was based, and upon which it was approved by the court below. It tacitly admits (p. 33) that the historical base used was insufficient and erroneous, but claims that that is immaterial as the result must be tested by the fair value found. It expressly recognizes (p 17) that the fair value rule governed the action of the Commission and must be applied in deciding this appeal. It contends (pp. 79, 80) that the fair value was fixed by the "exercise of a reasonable judgment having its basis in a proper consideration of all relevant facts", including actual cost, reproduction cost and other evidence. Despite the express statement in the decision and in its answer that going value was not included, it says (p. 78) that the fair value figure is proper because it "greatly exceeds the actual cost"[1] and "is in excess of its present cost after giving full effect to the *present* level of prices"[2] and therefore "it is apparent that there is included in said figure a substantial allowance for going concern value," and that "this is particularly evident" because the figures "include the artificial gas manufacturing facilities."

In substance, the brief of the Commission is an appeal to sustain the validity of its order, not upon the basis of the theories and methods actually followed in arriving at its decision, and approved by the court below, and not upon the facts shown by the record before the Commission and the court below, but upon the grounds that this Court,

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[1] In fact the fair value fixed is over $2,000,000 less than the cost of the property with proper allowance for working cash, material and supplies and 1930 additions, without going value. (See p. 210 of our brief.) It is over $11,000,000 less than such cost plus the minimum going value shown by the evidence.

[2] The fair value figure is more than $19,000,000 less than the minimum evidence of reproduction cost plus minimum going value.

(a) should take judicial notice of a decline in construction costs occurring since the submission of the case in the court below, and claimed to cause a decrease in the value of the property, and

(b) should find as a fact (although neither the Commission nor the court below did so) that the gas manufacturing plant of the Company should be valued at less than the value fixed therefor by the Commission, and, that the rate base fixed was higher than was proper, and sufficient to compensate for the omitted items.

It is sought in that way to create a cushion, so to speak, sufficient to compensate for the errors of the Commission and the court below in fixing the rate base and in estimating the revenues and expenses under the rates prescribed.

The net result, so it is urged, is that a fair value figure expressly intended to include no allowance for going value, and intended to ignore the original cost and cost of reproduction of large elements of the property because they had erroneously been charged to the wrong account on the books, is nevertheless now a proper figure because of the compensating effect of a declining price level and the alleged questionable usefulness of the plant.

THE ISSUES AS DISCLOSED BY THE BRIEFS.

It is now strenuously asserted that the fair value rate base fixed by the Commission is a "judgment" figure, arrived at only after a due and careful consideration of all of the evidence required by law to be considered in a finding of fair value. This is but a belated attempt to immunize the decision from attack and is based upon a repudiation of the theories and methods which the Commission itself, in its decision, not only disclosed but sought to jus-

tify, and upon a belated denial of the allegations and admissions of its own answer.

THE COMPANY'S POSITION.

We assume that this appeal will be disposed of upon the record. We contend that upon that record it is clear that the action of the Commission was arbitrary and that the rates prescribed are confiscatory. We maintain that there are no real issues of fact presented for decision, and that the errors of the Commission and the court below are apparent from a reading of their opinions in the light of the evidence, and necessarily resulted in the fixing and approval of confiscatory rates. In our brief (p. 208) we showed that this is so, using the Commission's own figures and estimates although they are deficient and result in values less than the true value of the property and returns greater than can be realized.

The Commission here seeks to sustain its order, not upon the basis of the methods actually followed in reaching its decision, nor upon the facts used as a foundation therefor, but on the basis that subsequent events, not possible to have been considered when it made its order, and certain compensating errors, serve to give validity to an order that was invalid when made. We submit that this effort is lacking in merit, logic and equity.

We contend that the Commission's present position is not sustained by the facts of record, and is not supported by any facts of which judicial knowledge may be taken. We will show that the decline in construction costs relied on in support of the Commission's contentions in this Court is wholly unrelated to the rate base fixed by the Commission; that it is impossible of appraisement as to its effect on the

value of the Company's property and that the effect of such reduction in the true value of the property as may be due to a decline in construction costs is outweighed by decline in earnings, increased investment and other changed circumstances not mentioned by the Commission. We have shown in our brief (p. 186 *et seq.*) that the manufacturing plant is used and necessary property and was properly included in the rate base, both by the Commission and by the court below. The Commission cannot now successfully claim that a valuation, clearly shown by the record to have been fixed by rigid application of an erroneous formula, is the result of an informed "judgment" which weighed all relevant facts. It cannot intrude an allowance for going value in a figure which the decision proudly stated excluded any allowance therefore, because the cost of advertising and solicitation had been included in operating expense. The decision was sustained by the court below upon the theories upon which it was based. The abandonment of those theories is not merely of academic interest. Although equally unfounded on fact and impossible of accomplishment the effort to rescue the decision by this change of front clearly shows the basic invalidity of the Commission's valuation methods and theories and the confiscatory character of the rates so prescribed.

WHAT THE COMMISSION ASKS THIS COURT TO DO.

The Commission asks this Court to:

(a) find that the value fixed as of 1930 has declined since the case was submitted (January 2, 1931) by taking judicial notice of a decline in construction costs, without any basis for appraising the effect of such decline on the value of this Company's property or the

effect on such value of additions that have been made to the property since that date; and

(b) find that the gas plant is worth less than it was valued by the Commission, and to make that finding for the first time on appeal, although both the Commission and the court below included the plant as used and useful property and appraised its value.

It asks this Court, on the basis of conditions existing in 1933, not appearing in the record, to find that the order made in November, 1930, was valid when made and that it has preserved its validity throughout the intervening period, not upon evidence of what actually occurred during that period but solely by taking notice of a single circumstance, without means for appraising the effect of that circumstance and without means of ascertaining other circumstances of equal or greater importance.

We have presented this appeal upon the record and we claim that it should be disposed of upon that record. If events which have transpired since the record was closed warrant any different treatment, the Commission has at all times been free to institute new proceedings where those conditions can be considered in the appropriate way. This has not been done. Instead the Commission seeks to have this Court dispose of the case by ignoring the facts shown by the record, and approve the results reached by the Commission by considering only one of the many circumstances which would now enter into the determination of the reasonableness of present rates.

OTHER CHANGED CONDITIONS.

In view of this contention on the part of the Commission, and solely by reason thereof, it becomes necessary to point

to other circumstances which finally would more than outweigh any change in the present value of the Company's property due to decline of the price level. We mention these matters not as proof of the invalidity of the order, nor to influence this Court in the decision of this case, but to point out the impropriety of the course urged by the Commission and the impossibility of disposing of the case in an equitable manner other than in the customary way, by a decision based on the evidence of record.

Among the other factors which have equal or greater weight than can be attributed to a change in prices are:

1. The actual revenues of the Company in each of the two years since the date of the order have been substantially below the Commission's estimate for 1930, those for 1931 being nearly $800,000 under that estimate (Compare R. 199 and R. 45);

2. The business of the Company, like other businesses generally, has declined substantially, the Company having sustained a net loss of more than 10,000 customers during 1932, and in December, 1932, the total was less than in December, 1929, one year before the challenged rates were to be effective. This decline is continuing at an accelerating rate.

3. The source of natural gas supply has shifted so that now at least 84 per cent of peak day requirements must be obtained from distant fields, and the locally available supply is less than 1/5 of that estimated in the record;

4. More than $2,000,000 additional investment has been made to the property of the Company;

5. It was necessary to manufacture gas in the plant and mix it with the natural gas to meet a deficiency in the supply of natural gas on at least one occasion during the winter of 1931-1932;

6. Commission engineer Brown, whose affidavit is relied on for the contention that the plant is of doubtful utility, testified under oath in a proceeding involving gas rates in Los Angeles, in October, 1932, that manufacturing plants are now necessary to prudent operation, that the change in source of supply to the distant fields of Kettleman Hills and Ventura County and the relation of total available supply to peak requirements makes it improper to rely on the natural gas supply; he said that he had changed his opinion since the affidavit he made in this case because of these facts, and moreover, stated that he did not intend his affidavit to imply that it is not practicable to use a mixture of natural and artificial gas without adjustment of appliances, but merely to say that straight manufactured gas could not be so used, although the Commission's brief, citing his affidavit, says (p. 45) that "Consumers' appliances may not be readily adjusted to burn the gas of lesser heating units";

7. The reproduction cost of money has very greatly increased;

8. The business depression has had a continuous and increasing effect in reducing sales and increasing the uncollectible revenue;

9. Taxes have increased substantially and are tending to increase to an even greater degree;

10. Published price indexes for the country at large give no real indication of the cost of reproduction of a property such as that of this Company, made up in large part from highly specialized construction, and take no account of local conditions which have served to maintain wage levels far above the average for the country as a whole. They represent "spot" prices that could not in fact be obtained if a property of this magnitude were to be reproduced, and give no indication of the prices that would prevail over the period of 4 to 6 years estimated to be required to reproduce the

> property. A reproduction cost of this property, based on current prices would show but a very moderate decline below the reproduction cost estimates shown of record.

We do not ask that these matters be taken as proof of the facts, but point out that they are of equal importance with the single circumstance as to which the Commission would have this Court take judicial notice to influence the decision herein (declining prices), in a manner not warranted by the record before the Court. We are prepared to prove these facts in the regular manner and offer so to do if the Court should feel that the case should be reopened for further testimony. We claim, however, that the record herein shows that the Commission's order was void in its inception and has remained void at all times since. The case can be disposed of upon the record and we ask that it be so disposed of. If changed conditions as of today warrant a new inquiry into the rates the Commission is free to undertake it at any time.

AUTHORITIES ON JUDICIAL NOTICE.

In *Arkansas v. Kansas & T. C. Co.*, 183 U. S. 185, 190, this Court held:

> "And as to judicial knowledge, the principle applies 'that the right of a court to act upon what is in point of fact known to it must be subordinate to those requirements of form and orderly communication which regulate the mode of bringing controversies into court, and of stating and conducting them'. Thayer, Ev. chap. 7, 281."

See also: *Mutual L. I. Co. v. McGrew*, 188 U. S. 291, 312; *Mountain View M. & M. Co. v. McFadden*, 180 U. S. 533.

In *Galveston Elect. Co. v. Galveston,* 258 U. S. 388, 402, a case involving the confiscatory character of street railway rates, this Court said:

> "We know judicially that the period has, in general, been one of continuous price recession, and that the current rates of return on capital are much lower than they then were. But we cannot know to what extent the important changes occurring have affected either gross revenues or the net return. * * *"

In that case no injunction had been granted and the decree protected the right of the Company to renew its attack on the rates. It was therefore held that the decree should be affirmed since the Court was unable to give any relief not prospective in operation. Here, however, the enforcement of the order has been stayed by the interlocutory injunction, which was continued pending this appeal. There is, therefore, a fund whose disposition is dependent on the decision herein and it is necessary that the past as well as the future be considered.

We have shown from the face of the decision and from the evidence that the order was arbitrary and the rates prescribed confiscatory. The case should be disposed of upon the record and enforcement of the order enjoined. This does not prevent the Commission instituting new proceedings in which all evidence relating to present conditions may be received and considered. The Company has no apprehensions as to the outcome of such a proceeding if conducted in accordance with the law of the land, instead of upon the erroneous legal theories here followed by the Commission.

GENERAL COMMENT ON THE COMMISSION'S ARGUMENTS

Certain of the arguments advanced by the Commission in its brief herein, require brief comment and reference to the portions of the record bearing thereon. We will deal with these matters as they appear in the Commission's brief.

GOING VALUE.

On page 13 it is said: "Although no finding was made as to the amount of going value, the said element was recognized by the Commission in the rate bases and return allowed thereon."

It appears that the finding of fair value is derived from the evidence of Valuation engineer Dufour of the Commission, who testified (R. 266):

> "This figure does not include any allowance for going value except as it may be reflected in historical cost. I have made no study of going value and do not know whether this property has a going value. I do not know what amount is so represented in the figure I have just named and have not tried to determine it, nor, so far as I know, has any representative of the engineering or valuation departments of the Commission attempted to determine going value. There is no separate figure included for such going value and no attempt has been made by me or my department to measure a going value of the property in this case."

In its decision (R. 41) the Commission said:

> "Were going concern to be treated as an independent item of value, it should be measured with due regard to actualities rather than upon theories and assumptions such as employed by Col. Miller. * * * Substance rather than form is to be considered. So viewed, this

Commission does allow for the so-called intangible going concern value *by treating its cost as a current operating expense.*"

The Commission's answer in this case says (R. 91):

"* * * admit that in fixing said fair value figure, the Commission did not include therein any independent item of value to represent the claimed elements of going value, but in this regard allege that in fixing said present fair value, the Commission gave consideration to the fact that the properties of plaintiff were going properties, that plaintiff possessed a trained personnel and organization; in this regard it is further alleged that said Commission also treated said alleged going concern value as a current operating expense. * * *"

The court below said (R. 112) that the Company "claimed a 'going concern' value of $9,228,667, which was rejected by the Commission" and held (R. 117) that "The large amounts claimed by the Company for * * * cost of attaching business (going concern value) $9,228,667 * * * we think were properly rejected as for their total amounts."

Circuit Judge Wilbur, in his concurring opinion (R. 135) said that "The Railroad Commission expressly refused to make any specific allowance for going concern value. This is directly in the teeth of the decisions of the Supreme Court of the United States. * * * It did, however, contend that all the elements making up going concern value had been paid for out of the current expenses of the company, notably the cost of attaching business and had thus been allowed."

It is thus apparent that the present contention of the Commission that it had made allowance for going value is

contrary to what it in fact undertook to do and did, and is contrary to the position taken in the court below in support of the order. For the Commission now to contend that it recognized or allowed for going value in the rate base is contrary to its unbroken line of decisions in which it has uniformly refused to make any such allowance in rate cases (as illustrated in the brief of the City of Los Angeles, p. 23), although making specific allowance therefor in condemnation cases.

RATE MAKING POLICY OF THE COMMISSION.

At page 21 of its brief it is said that "The fact that the California Commission in the past has manifested a preference for the use of the historical cost method of rate making does not mean that the Commission has been unmindful of the majority opinions of this Court holding that utilities are entitled to earn a fair return on the fair value of their property." In a footnote to the brief it is said that in twenty years of regulation but one of its orders has been held confiscatory.

The explanation for this is found in the dissenting opinion of Commissioner Decoto (R. 67) where it is pointed out that the Commission "has clung ostensibly and theoretically to the historical rate base. In reality it has given effect to the different elements mentioned by the federal courts including fair value including going value by allowing a rate of return between 8 per cent and 8½ per cent on historical cost. * * * With this arrangement our public utilities have been content. During the last two years this commission has shown a tendency to cut the rate of return upon an historical rate base from between 8 per cent and 8½ per cent to 7 per cent, which reduced the rate of return

upon a fair value basis to 6.12½ per cent to 6.3 per cent. This is confiscation and not regulation. It cannot be expected that our public utilities will long content themselves with such a return. The result will be an appeal to the courts for proper redress. This is in effect a shirking of its responsibility by the commission and will lead to an era of regulation by the courts."

Here the rate of return allowed is but 7 per cent whereas in earlier cases involving this Company's rates the return allowed (although never realized) was as high as 8.14 per cent.

HOW "CURRENT PRICE LEVEL" WAS DERIVED.

In its treatment of current price level costs (Brief, p. 39 *et seq.* and particularly at p. 41) it is suggested that the figure of current price level used as the basis for the finding of fair value is obtainable "by applying to the actual historical cost of the properties as of December 31, 1929, as reflected by the books of the company, price factors converting the said historical cost to price levels prevailing on June 15, 1930", quoting the affidavit of Commission engineer Dufour.

But the Commission in its answer (R. 91) admitted that the figure so used (as is also shown by the dissenting opinion of Commissioner Decoto (R. 70)) was not obtained in this way at all but was compiled as a reproduction cost estimate, using spot prices of June 15, 1930, and including overhead construction costs at 6.35 per cent. Before the Commission no definition of current price level cost was ever given nor was it indicated in any way that such a "concept of value" was contemplated.

In our opening brief herein (p. 87 *et seq.*) we pointed out that such a study does not and cannot give historical cost translated to current prices. Being based on reproduction methods it necessarily contemplates quantity and not unit purchases, modern machinery and not pick and shovel work, avoidance of the duplications that inevitably occurred in historic construction and many other matters which tend to reduce reproduction cost below historical cost. In the face of the evidence of record, to which attention was called in our opening brief and which is undisputed, it cannot be said that the same figure can be obtained in a wholly different method.

The table of "Current Price Level" estimates on page 43 of the brief shows only the appraisal of physical properties, made up from reproduction cost estimates based on spot prices as of the various dates shown and with construction overheads computed at the admittedly deficient rate shown on the Company's books. These figures include nothing for going value, nor do they include the amounts allowed by the Commission for Working Cash Capital, Material and Supplies and 1930 Additions, aggregating $1,862,103. As has been pointed out these figures, by reason of the method by which made up, cannot represent what the definition given by the Commission for Current Price Level requires, viz., "the assumption that the property was put together historically but that during its entire life prices had been those now current". (R. 37)

Doubtless by inadvertance it is said in the Commission's brief that these figures "constitute reliable evidence of value, to which the Commission and the Court below could accord appropriate weight in its determination of fair value." The third item shown, with prices as of December

15, 1930, was presented in the court below, but could not have been considered by the Commission, the pricing date being nearly one month subsequent to the decision.

THE GAS MANUFACTURING PLANT.

This subject was dealt with fully in our brief (p. 186 *et seq.*) It was there shown that the plant was constructed within the past ten years, with the advise and almost at the insistence of the Commission; that in fixing rates for natural gas service it was definitely stated that the plant should be continued in service; that contracts for natural gas supply, entered into with the specific approval of the Commission, require its continued operation as part of the price paid for natural gas; that every responsible and experienced gas executive believes its continued operation to be essential, and that there is no large city served with natural gas without such a stand-by facility, new ones having recently been built by Col. Miller's firm in Pittsburgh and Buffalo.

From the Commission's brief it is clear that it now seeks to justify a deficient finding of value by arguing that the plant which was included therein is of "questionable usefulness". But both the Commission and the court below included the plant in the used and useful property, on the same basis as all the other property of the Company. The Commission engineer who testified to the accrued depreciation which the Commission in its decision approved and found correct, said that the depreciation computed by him embraced "all factors of wear and tear, inadequacy and obsolescence" (R. 288) and later repeated that his estimate of the present depreciated value included "both physical and functional deterioration to the extent they exist." (R.

293) The court below found that the values as fixed by the Commission were correct. It must therefore be taken as having approved the methods and theories followed by the Commission and as having approved the inclusion of the properties included by the Commission and its finding of the accrued depreciation including obsolescence and functional deterioration.

It thus appears that whatever adverse effect on value of the plant was found to exist had been appraised by the Commission engineers and was taken into account in the value fixed by the Commission for the Company's property. Both the Commission, and the court below, included the plant as used and useful property, valued it, and appraised its accrued depreciation (both physical and functional, including inadequacy and obsolescence) in arriving at the figure of fair value. But the Commission now asks this Court, in effect, to make for the first time a finding that the plant should be valued at an amount less than it was valued by the Commission, and by the court below, in order to compensate for various elements of value improperly excluded by the Commission.

How it can be contended that the failure to measure and allow for going value and proper construction costs, both of which were excluded by the Commission, is compensated by the inclusion of the gas plant, is beyond comprehension. These elements of value are essentially different in nature and in no sense compensate for each other, entirely apart from the demonstrated need of the plant to assure uninterrupted service, as shown in detail in our opening brief. If the Commission has ground for believing that the plant should be excluded or valued at less than was here included let it institute proceedings to that end. It

cannot justify here its failure to include demonstrated items of value in the rate base, by asking this Court on appeal to find as a fact (what neither the Commission nor the court below found) that the plant is worth less than the amount at which it was valued by the Commission, approved by the court below, and that this exactly compensated for the errors of the Commission in excluding going value, in refusing to consider true overhead costs on either the historical or reproduction basis, and for other errors of valuation aggregating many millions of dollars.

FAIR VALUE.

Under this heading of its brief the Commission contends that the fair value figure was reached only after considering all evidence as to value, and is not the result of rigid adherence to a formula. However, as has been pointed out, the figure was fixed by adhering to a very rigid formula, one that gave no consideration to actual cost, cost of reproduction, going value or present value of the property.

The Commission says (p. 67): "The Commission decision shows that the fair value determination was made only after a complete and careful consideration of the entire record and particularly all of the evidence on valuation." Similar protestations are all too frequent in the decisions of Commissions. In *Monroe G. & F. Co. v. Michigan P. U. C.*, 292 Fed. 139, 143, it was said:

> "It will be noted, however, that pursuant to a common practice the report seeks to immunize itself against attack by a careful declaration that no one element is given controlling effect in fixing the rate base, but that

> actual cost, investment, capitalization, reconstruction cost, depreciation, etc., are given, and each is given, due weight in reaching the general composite conclusion. As Mr. Justice Brandeis points out, such a report, like the general verdict of a jury, suggests immunity to any attack which depends upon showing that the Commission gave excessive or insufficient force to any one element. We do not see that an otherwise appropriate judicial revision can be escaped in this manner. It is the duty of the court to determine the rate base from the evidence before it; and while there must be great hesitancy in overturning a conclusion reached by the Commission, after it has considered all relevant facts, neither presumption nor express statement by the Commission that it has given due weight to every one can prevail against a contrary inference required by the proofs."

In *Bluefield W. W. & I. Co. v. Public Service Commission*, 262 U. S. 679, 688, this Court quoted from the opinion of the Supreme Court of West Virginia as follows:

> "From the written opinion of the Commission we find that it ascertained the value of the petitioner's property for rate-making (then quoting from the Commission) 'after maturely and carefully considering the various methods presented for the ascertainment of fair value and giving such weight as seems proper to every element involved and all the facts and circumstances disclosed by the record'."

Nevertheless, this Court found that the Commission there had failed to give due consideration to the element of reproduction cost and held (at p. 692):

> "The valuation cannot be sustained. Other objections to the valuation need not be considered."

At pages 71 and 72 of its brief a table is presented which is said to show "the various estimates and data on valuation of Company properties as of December 31, 1929, which were before the Commission". Items 16 to 18 of this table show prices as of December 15, 1930. These are probably included by inadvertance, but they certainly were not before, or considered by the Commission in making its decision on November 24, 1930, as is stated on page 70.

The prices shown in that table are for physical properties only and do not include Working Cash Capital, Materials and Supplies or 1930 additions, appraised in the decision (R. 27) at $1,862,103, but which in reality are a much greater sum. It should also be remembered that the Commission did not fix $65,500,000 as the fair value but found (R. 43) "Subject to deduction for accrued and realized depreciation in a sum of approximately $7,650,000, the fair value * * * for the year 1930 does not exceed $65,500,000". In its Answer (R. 88) it is alleged that the value for 1930 was not over $57,850,000. Deducting the $1,862,103 from this figure leaves $55,987,897 to be compared with the figures shown in the table on a depreciated basis. The only one of those figures justified by any testimony of record was item 5, Dufour's estimate of reproduction cost, depreciated, $64,179,071, more than $8,000,000 in excess of the fair value found by the Commission. This does not include anything for going value, which was not appraised by Mr. Dufour, nor any of the Commission's engineers.

It should also be remembered that the record shows that the so-called straight line estimates of depreciated value were said by the witness who presented them to represent a "mere mathematical relationship" (R. 293). He also testified (R. 293) that "I do not feel that the straight line es-

timate is a correct basis of estimate. It does not represent the value of the property."

We have pointed out that most of the figures shown in this table were unsupported by any testimony as to their applicability to the value of the Company's property. They were no more evidence as to its value than would be the multiplication table. The only figures adduced by any Commission witness as to which any testimony was offered that they represented value of the property were items 3 and 5 of the table on page 71 of the Commission's brief, the reproduction cost estimate, with four year average prices and 22.32 per cent overheads. From this welter of figures, the Commission chose as its basis for fair value the lowest of all, derived from a reproduction cost inventory, applying spot prices of June 15, 1930, and 6.35 per cent for overheads, derived from admittedly inadequate book charges during a part of the Company's history, excluding any allowance for going value. Such a figure failed to give any weight or consideration whatever to actual cost, cost of reproduction, or present fair value. In fact it did not even give any consideration to historical cost adjusted to current prices since the methods by which it was derived made this impossible.

DECLINE IN CONSTRUCTION COSTS.

It is contended (p. 75) that "This Court can properly take judicial notice of the decline in building and material prices which have taken place since the case was submitted before the Commission", and reference is made to various indexes as indicating the amount of this decline. Particular reliance seems to be placed on the "construction cost index" shown on page 77. This index is based only on the

prices of steel, cement, lumber and the wages of common labor. It takes no account of specialized machinery and materials required for the construction of a gas plant, nor of the wages of skilled labor. It does not include any overhead construction costs, which the Commission engineers testified would amount to nearly one-fourth of the cost of physical property. It wholly ignores the very large transportation cost which would be incurred in constructing the Company's plant in Los Angeles. Necessarily such an index can take no account of local conditions and the record herein shows that there is a marked differential over costs in the large industrial centers of the East always existing in Los Angeles.

The present cost to reproduce the property would be evidence to be considered in arriving at a present fair value. But this means the actual cost of reproduction, not an "adjustment" of inadequate book costs to current price level. In view of the manner in which the Commission's fair value base was fixed it is impossible to apply any index, even if an index figure could be found which measures the value of the property here involved. The fair value was based on June 15, 1930, spot prices, the lowest prices of record before the Commission. Admittedly it would take from 4 to 6 years to construct the property. Average prices over such a period must necessarily be used in determining the cost of reproduction. The overhead construction costs were included only to the extent of 6.35 per cent. The minimum for these costs is shown by the record to be 22.32 per cent of labor and material items. The fair value fixed was $10,000,000 less than the minimum estimate of reproduction cost shown of record, as to physical property only, without going value and with-

out the Commission's own allowance of $1,862,103 for Materials and Supplies, Working Cash and 1930 Additions. The fair value figure is more than $19,000,000 less than the minimum estimate of record as to cost of reproduction, plus the minimum appraisal of going value. If present prices are to be considered there must also be taken into account the additions that have been made to the property since 1930. Also there must be considered average prices over the period required to build the property, not merely spot prices which exist solely by reason of the practical suspension of construction work, and which no sane person would take as the basis for a bid on a project requiring 4 to 6 years for completion. We submit that the alleged decline in construction costs is wholly inapplicable to the fair value figure fixed in the decision and that any decline that has occurred is wholly insufficient to account for the omission of more than $19,000,000 in value demonstrated by the evidence to exist.

THE COMPANY'S CLAIMS AS TO VALUE.

The Commission also implies (Brief, p. 65) that the Company has abandoned its claims as to the value of its property. Such is not the case. The issue here is not whether the Company has established the value claimed by it but is whether the value fixed by the Commission is sufficient. The Company is not seeking an increase in its rates, dependent upon establishing the value claimed by it. The Commission is seeking to impose a reduction of rates, below those established as just and reasonable a short time before the present order was made, and that order is here attacked as confiscatory because the base fixed is too low. The Company still insists that the values claimed by it are

established by the record. To lighten the labors of this Court we have not sought to impose the burden of examining the entire record to choose between conflicting claims on disputed items of valuation, but have confined our argument to the minimum evidence of record, showing that on the basis of the Commission's own evidence the rate base fixed was inadequate, the return estimated excessive and the rates prescribed confiscatory. This is not an abandonment of our claims as to the true value of the property. We are satisfied that if the Court undertakes the task of examining the evidence the Company's claims will be found to be fully sustained. We do not feel that it is necessary so to do and that the Commission's own evidence and the most adverse figures in the record are sufficient to demonstrate the invalidity of the order.

ACCRUED DEPRECIATION.

The Commission criticises our estimate of accrued depreciation. We will not argue that point because for the purpose of this appeal we have taken as the basis for our argument and calculations the Commission's own finding that the accrued depreciation is $7,650,000. There is no issue before the Court on that point.

The Commission did not find the fair value to be $65,500,000, but did find it to be that amount "subject to accrued and realized depreciation in the amount of approximately $7,650,000 (R. 43). Although treating depreciation "as a deductible item to arrive at fair value" (R. 44) it chose to test operating results by ignoring the depreciation, saying (R. 44) "Should a depreciated rate base (fair value) be used the depreciation annuity would have to be computed only for the expected life of the property and

would be more than an annuity computed on the basis of age plus expected life." Commission engineer Wehe computed a 6 per cent sinking fund annuity of $1,072,000 to be used with the rate base chosen by the Commission. He is the same engineer who computed the accrued depreciation found by the Commission, and who, at the same time, and using the same lives, computed the straight line annuity of $2,306,606 used in the summary on page 208 of our brief.

The Commission attempts to escape our contentions by asserting (without citation of any authority) that it is entirely proper to use a sinking fund annuity and an undepreciated rate base. We have shown (p. 138 *et seq.* of our brief) with reference to many decisions of this Court, that this cannot be. The concurring Judge below pointed this out (R. 154). The Company is entitled to a return on the present value of its property, which must be determined by deducting depreciation, if any, accrued thereon. The Commission found the depreciated value, $57,850,000 and the same engineer whose testimony afforded the basis for that finding testified that the depreciation annuity for such value is $2,306,606, the minimum straight line depreciation annuity estimate of record.

The Commission argues that it is in effect allowing a depreciation annuity of $1,633,041 (Brief, p. 82) because there will be added to the annuity to be charged to operating expense interest on the reserve amounting to $561,041. Even this is $400,000 less than its own engineer testified is the annuity usable with the rate base fixed. It ignores the fact that the reserve is the Company's property, that interest thereon is paid by the Company itself out of its net income, and that only by coincidence could the sum of a sinking

fund annuity and interest on a reserve ever equal the proper straight line annuity.

The Commission also asserts (again without citation of any authority) that if straight line annuity is used then the rate base should be diminished by depreciation computed on the straight line basis, shown by Mr. Wehe's "mathematical relationship" figure to be $15,530,656. Thus it is sought to still further reduce the rate base to approximately $50,000,000, over $7,000,000 less than the depreciated fair value expressly found by the Commission. Mr. Wehe testified that this calculation was a "mere mathematical relationship" and that it "did not represent the value of the property". He testified that the accrued depreciation, on the base used by the Commission for its fair value finding, was $7,650,000, the amount found by the Commission. He also testified that this deduction included both physical and functional depreciation, inadequacy and obsolescence to the extent they exist.

The minimum fair value found by the Commission itself (which we have shown to have been derived by wholly erroneous methods and to be utterly inadequate) is $57,850,000. The minimum depreciation annuity to be used with that value is shown to be $2,306,606. The Company, under the decisions of this Court (discussed in some detail at page 138 *et seq.* of our brief), is entitled to earn a fair return on the value of its property, and in computing such return there must be deducted an amount which will be sufficient to spread over the expected life of the property the estimated cost of its retirement, based on the present value of the property. Such a minimum figure is shown by this record to be $2,306,606. The Company's figures indicate a much higher amount, $2,830,000 according to Mr. Masser

(R. 446) and $2,830,487 according to Mr. Luick's testimony (R. 514).

REVENUES.

It is repeatedly asserted by the Commission that the estimate of revenues used in its decision are based on the estimates of Mr. Masser, the Company's Vice-President. It appears however that all of Mr. Masser's figures were "adjusted" by the Commission before being used. Mr. Masser estimated 1930 revenue, at one time, as $16,187,623 (R. 352). The Commission in its decision used $16,415,000, $218,000 higher than Mr. Masser's estimate. But Mr. Masser also testified (R. 357):

> "I have made no estimate of sales and revenue for 1931 because I feel there are so many variables that such an estimate could not have been made with any reasonable degree of accuracy. Considering everything, however, I do not believe that if I were compelled to make an estimate that the revenues for 1931 would exceed those shown for the year 1930. There has been a downward trend in sales for over a year."

After having presented his 1930 estimate, at a later hearing before the Commission, he testified (R. 358):

> "Since submitting estimates of revenues for 1930 in this case the Company has experienced a further loss of meters and I think my estimates of revenue are too high. I believe the revenue for 1931 would be substantially the same as estimated for 1930."

In his affidavit in the court below Mr. Masser set forth his estimate of future revenue and expenses, using the latest available twelve month period, that ended October 31,

1930. (R. 445.) In his reply affidavit (R. 509) he pointed out that the temperatures during that twelve month period, were in his opinion normal, and approximated the average of the preceding five years. He thus estimated revenue under the reduced rates prescribed by the order at $14,352,-450, as compared with the figure of $15,003,000 (R. 47) used by the Commission.

On page 89 of its brief the Commission sets forth a comparison of actual revenues for 1928 and 1929 with the "adjusted" estimates used by the Commission as the basis for finding the existing rates unreasonable and for prescribing new, reduced rates. It is pointed out that the excess of estimated over actual revenues for the two years is but $300,000. Doubtless by oversight, the comparison made for the year 1928 is with actual revenues accruing under rates substantially higher than those now in effect, which were reduced by the Commission when it prescribed the present rates, effective December 1, 1928. The comparison, therefore, is meaningless as a measure of the effect of the "adjustments" made by the Commission.

It is possible to reduce 1928 revenues to approximately the present basis and the following table does this, also comparing actual revenues for the succeeding years with the "adjusted" revenues used by the Commission as the basis for its finding that the existing rates are unreasonable and for prescribing new rates. These estimates are all based on existing rates and not on the reduced rates prescribed which would be approximately 9 per cent lower.

COMPARISON OF ACTUAL AND "ADJUSTED" REVENUE.

Year	Actual Revenue	"Adjusted" Revenue
1928	$14,394,240 [1]	14,959,000
1929	15,801,208	15,989,000
1930	16,007,498 [2]	16,415,000
1931	15,635,252 [3]	16,415,000 [4]
Total	61,838,198	63,778,000

The "adjusted" revenue for the four years exceeds the actual by $1,939,802, an average of $484,950 per annum. The excess of "adjusted" over actual revenue for the year succeeding the making of the order was $779,748. For the three years used by the Commission as a test the excess was $1,160,054. The greater part of the deficiency is directly reflected in net revenue. The Bill shows that the reduction of approximately $1,300,000 in gross ordered herein would reduce net revenue by $1,100,000 (R. 12).

Estimates of revenue under the reduced rates prescribed by the order herein are shown at page 129 *et seq.* of our brief.

In view of these facts and in view of the testimony of Commission engineer Guillou that the Commission's practice of fixing rates on "adjusted" revenues based on theoretically normal temperatures would have resulted in the Company having failed to earn the return found reasonable in each of the six years preceding the order (and the same would be true for the year succeeding the order, R. 199) it is evident that the standard of normalcy chosen and the method of "adjusting" actual to "normal" revenues must

[1] Reducing revenue shown p. 89 of Commission's brief by 3%, the approximate reduction made in 1928 made in establishing the existing rates, R. 342.

[2] Taken from Appendix to Commission Brief in court below.

[3] Affidavit of W. E. Houghton, R. 199.

[4] Using same estimate for 1931 as made for 1930.

be inherently defective. It is all very well to estimate and "adjust," but when actual experience for seven consecutive years shows that in each year throughout that period such estimates would have substantially exceeded actual experience it is evident that some other standard of adjustment is required. The Company's estimate (Our brief, p. 210) is reasonable and in accord with the experience of the past six years. Operating expenses cannot be paid out of estimates and theory must yield to actual experience.

OPERATING EXPENSES.

There is a dispute as to operating expense only in respect of two items. It is idle for the Commission to talk about other items of operating expense and speculate as to whether they were "generous" or not. The record shows that large items of expense occur each year and that the total allowed by the Commission is in fact less than warranted by the evidence. However we have used the Commission estimate except for the two items discussed in our brief.

DEPRECIATION ANNUITY.

In its discussion of the depreciation annuity (p. 99 *et seq.* of its brief) the Commission does not seriously question the propriety of using the straight line annuity shown in the testimony of its own engineer, Wehe. But it asserts that if such annuity be used it is also necessary to use a rate base obtained by deducting accrued depreciation on a straight line basis from the undepreciated fair value rate base. By repeated assertion it contends that this claim has been "demonstrated", without citation of any authority and ignoring the many authorities cited in our brief. The rate base must be present fair value. That can only be

obtained by the deduction of actual depreciation. It cannot be obtained by the deduction of an amount which the Commission engineer states is a mere mathematical computation, and is twice the amount of the actual depreciation found to exist by the Commission. It is unnecessary to repeat the discussion of this question which appears at page 25 hereof, and at page 138 *et seq.* of our brief.

The Commission contends that the depreciation annuity was properly reduced below the amount previously allowed in the 1926 and 1928 rate cases because the reserve is excessive. The reserve is $9,350,000. The Commission found accrued depreciation to be $7,650,000. Yet at the same time it contends that the accrued depreciation should be computed on the basis of a pure "mathematical relationship" by which the accrued depreciation becomes $15,530,656. In the next breath the Commission contends that there should be deducted from the rate base the entire gas plant, valued at an amount considerably in excess of the present reserve, constructed within the past ten years almost at the insistence of the Commission, and included by it in the rate base found herein. These utterly inconsistent claims demonstrate the artificial nature of the Commission's depreciation theories.

RATE OF RETURN.

The Commission (Brief, p. 113) says that the cost of money, necessary to be considered "is simply the annual cost or charge against the utility's net income because of fixed interest and preferred dividend requirements". It thus ignores completely the necessity of earning on the common stock, as well as the cost of issuance and sale of the senior securities and the discount or premium in con-

nection with the refunding of one security issue by another. The return allowed barely exceeds the cost of money for the senior securities.

In our opening brief we pointed out the necessity of including in the cost of money the cost of securities refunded by current issues, since in no other way could the company afford to undertake refinancing when lower interest rates made such operations possible. Mr. Sinsheimer, a witness for the Company in this case, who for many years was bond and financial expert for the Commission testified (R. 435) that throughout his experience both with the Commission and out of the Commission he had heard of no other way in which the cost of money was computed.

As to the suggestion that the cost of common stock money may be ignored we need only point out that such a theory would result in holding that no return at all need be allowed if a utility had only common stock outstanding. The fair return protected by the Constitution is the return to the Company and not the apportionment thereof to the various classes of its security holders.

The Commission likewise says (p. 117) that "Continued additions to surplus in the amount shown are unnecessary Every contingency is provided for by other reserves"; and (p. 110) that the risks of the business "are nominal", and (p. 119) that the return of the Company "is one of the most stable of all business undertakings".

The contention that the risks incurred by the Company "are nominal" and that "Every contingency is provided for by other reserves" is hardly consistent with the contention here made that the entire value of the gas plant constructed within the past few years should now be ignored and eliminated from the rate base, thus destroying

a $10,000,000 investment made with the advice and practically under the order of the Commission itself. It is inconsistent with the undisputed fact that the Company under Commission regulation has for twelve years failed to earn, under the rates prescribed, the return found reasonable, on an unquestionably deficient rate base. It is inconsistent with the fact that the Commission insists on making rates on estimates which its own engineers say would actually have resulted in a failure to earn the allowed return for the six years preceding the present order, and shown by the record to be equally true in 1930 and 1931.

In our brief (p. 155 *et seq.*) these questions are discussed at length, and we submit our contentions are not answered by the assertions now made.

It is also claimed (p. 120) that "The Commission properly took notice of the lessening cost of money". This Court may with equal propriety take notice of the greatly increased cost of money which has accompanied the decline in price level so strongly relied upon by the Commission.

At page 122 of its brief the Commission discusses the earning position of the Company under the rates prescribed. This discussion, it will be noted, is predicated on the estimates (not realized in seven years) used as the basis for its decision, and is confined to the earnings on the par value of the Company's stock, ignoring depreciation and other reserves which are essentially a part of the general capital of the Company. Even so it shows but a nominal return. On the true value of the Company's property, on the true investment in the common stock, the return actually to be realized under the rates prescribed is wholly inadequate and confiscatory.

CONCLUSION.

While subject to regulation the property of the Company is private property. The Company, and not the Commission, is the manager of that property. Under the decisions of this Court the Company is entitled to a reasonable return on the fair value of that property, irrespective of its cost, or the manner of its acquisition.

The Company had been under regulation of the Commission for sixteen years when the order here in question was made. For twelve of those years it consistently failed to realize, under the rates prescribed by the Commission, the return allowed, on a rate base which was necessarily less than the current fair value of the property. During this period the deficiency below the return allowed was over $4,000,000. Nevertheless the Company continued to expand its property, to invest in additional facilities to meet the growing needs of the community and to give the best possible service. Apart from a temporary increase during the war period and immediately following the rates charged the consumers on a heat unit basis consistently were reduced and the rates now in effect are the lowest in the history of the Company.

During the past four years the Company has had its rates reduced twice and the present proceeding represents the third attempt to reduce rates, not because the rates are inherently unreasonable, but solely because the Commission thought that had conditions been different than they were, the Company would have earned an "adjusted" revenue more than the Commission deemed reasonable. This, we submit, is not the regulation of rates, but the limitation of profits, profits not actually received but those that might have been received under conditions that did not exist.

This result was accomplished by fixing a value which was arrived at on a purely arbitrary formula, one which ignores actual cost, present cost of reproduction, and present fair value of the property, and substitutes a combination of unrelated elements whose sum can have no bearing on any of the facts which this Court has held must be considered in determining the fair value of utility property. It is now contended that all the infirmities inherent in the order that was made are cured because of subsequently occurring changes in price level, whose effect on the value of the Company's property cannot possibly be approximated from the record before the Court, and because the Commission included in the property the gas plant, which it now says is of "questionable usefulness". Instead of supporting the validity of the order on the merits of the theories and methods followed in its making it is now sought to support it by fortuitous events occurring subsequent to its issuance. Instead of showing the propriety of the value fixed it is now sought to show that the value was improper and that errors of inclusion and omission exactly balanced each other, without any substantial evidence of record that any item of property was improperly included, and with no evidence whatever to show that adverse effects on value which the Commission was unable to appraise in dollars balanced omissions aggregating at least $19,000,000.

A weighing of the evidence of record demonstrates the propriety of the Company's claims as to the value of its property, summarized at page 210 of our brief. But it is unnecessary to go that far. The Company is seeking no increase in rates, dependent upon establishing the values claimed by it. The issue is not whether the Company's claim of value is sustained. The issue is whether the Com-

mission's value is deficient. The record shows that it is, and necessarily must be. Errors, apparent from the face of the decision, cannot be cured by protestations that the result is a "judgment figure" arrived at by fair consideration of all relevant testimony, when the record and the opinion of the Commission shows that it is not.

On whatever basis the order be considered, we submit that it has been shown to be arbitrary and the rates therein prescribed are shown to be confiscatory. We submit that the decree of the court below should be reversed and that it should be directed to enter a decree permanently enjoining enforcement of the void order of the Commission.

Respectfully submitted,

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